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DOW THEORY LETTERS, INC.

"The Market as Interpreted under the Dow Theory"

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A SPECIAL STUDY

COMPARISONS: Because of (1) the abnormal length of the post-war rise, (2) the extent of the current overvaluation in stocks, (3) the speculative "third phase" characteristics which have accompanied the market since 1959, (4) the degree of excess and inflation which is now part of almost every segment of American life, I have (over the past few years) made occasional comparisons with the period of 1928-29. I believe a few further details about that equally extraordinary period would be worthwhile at this time.

In the Wall Street Journal, January 1, 1929, Hamilton observed: "The unprecedented stock market has plainly upset the calculations of the conservative people." Later in the same editorial Hamilton quipped: "Lord Beaconsfield once described marriage as the triumph of hope over experience. Perhaps that term might be applied to the stock market."

Writing a few years after the 1929 crash period, Richard Schabacker (editor of Forbes and an outstanding market student) noted: "It looked very much as though a broadening top was being formed during this period (January to June, 1929) to signal the major reversal of the long bull market." The potential 1929 broadening pattern in the Industrials reversed to the upside, however, and Schabacker wrote: "It (the broadening pattern) reversed in May, thus saving the technical picture for the bull cause."

Looking back on the whole 1929 episode, Schabacker asks (1934): "What were the fundamentals? The long bull market of nearly eight years had carried prices up to new high records for all time, which were not justified by any form of logic. The stock market was as inflated as any real estate boom, or any other type of boom. Stocks were selling at 15 to 50 times their annual earnings against the basic ratio of 10 times such earnings. Business had been good for several years, interest rates had been low for several years, the market has been advancing for five years. Voices were raised in the familiar cry of 'New Era'. The old rules were dead. There would be no more bear markets. Generally, the public knew the situation was unhealthy, but each hoped to make another dollar and get out before the final day of reckoning."

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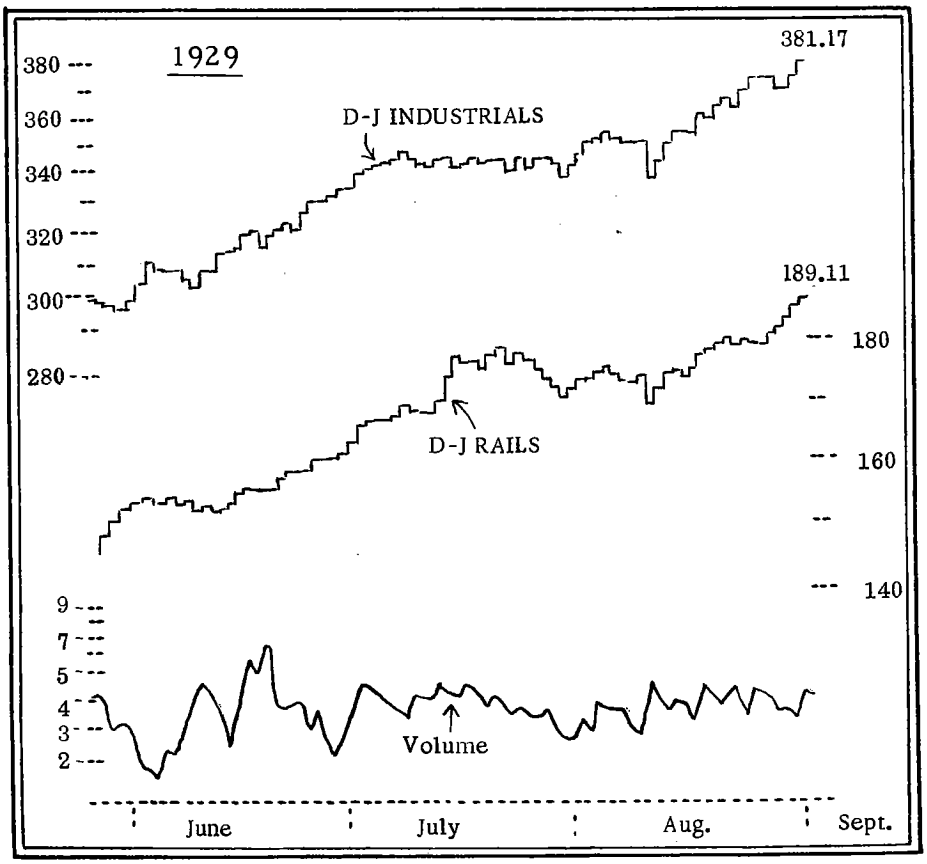
PRICE MOVEMENTS: Many market students are of the opinion that the Averages must or will provide early indications of trouble before that trouble actually materializes. As a matter of fact, this has generally been the case, and the great majority of major and intermediate reversals have been presaged by a non-confirmation in one Average, a divergent movement, or a persistent lag in one or the other indicator. The year 1929, however, proved a major exception to the rule. The final 1929 rise was in the nature of a massive speculative "blow-off", a violent insistent thrust into higher and higher ground. It was an extraordinary movement, and it ended in an extraordinary way.



I have included a rare daily chart showing the June-September, 1929, action in the D-J Averages together with daily volume. This chart is drawn to exactly the same semi-logarithmic scale as chart # 2 on page 1 of each regular Letter. For this reason, the current movement may be compared with the final rise in 1929.

The advance pictured in the accompanying chart occurred following a narrow five-month series of fluctuations in the Averages, a sideways movement which lasted until May, 1929. The advance-decline ratio had "topped out" earlier (1928) together with many leading and secondary issues. Despite the major divergence in price and breadth, the two Averages pushed out of their consolidation in June, 1929, and started up. An historic and breath-taking rise followed which carried both Averages to all-time highs in September (it is this action which is pictured on the daily chart). The final 1929 advance was actually more sporadic than the current one (note the corrective action of July-August, 1929), but the rise was more violent in terms of percentages.

On September 3, 1929, the two Averages recorded joint peaks as shown on the chart. There was nothing in the action of the Averages or in volume to suggest that September 3 was the final, fateful top. If there were signs of danger in 1929, they were signs that had been present for many months. Fundamentally, the danger signal in the market was the extreme overvaluation in many stocks and particularly in investment-grade stocks. Technically, the danger signal was the fact that the A-D ratio had topped out and the Averages were rising without new highs in breadth. But why September 3, 1929, was chosen as the day for the final peak will never be understood. People simply looked back on September 3 — and they knew that the top had passed.

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The little group of charts below may be considered measurements of speculative forces within the economy (these charts are from the Federal Reserve Bank of Atlanta — Bulletin, December, 1963). Margin accounts in brokerage offices (chart A) have now expanded to approximately 1929 levels. Thus, there is a tremendous amount of credit and leverage in today's stock market.... Chart B traces the rise of long-term financing in new cars and in FHA housing loans. Here it should be noted that the longer the loan, the riskier the loan (as far as the banks are concerned)..... The rate of apartment house building (Chart C) has increased steadily since the mid-1940's. A sharp rise in apartment house and office construction is characteristic of the late stages of a building boom..... Finally, chart D shows that business failures (in dollar totals) are now at an all-time high, even though the percentage of firms failing per 10 thousand is well below the late-1920's. The percentage, however, has risen steadily since 1945.